AGENDA ITEM NO.
M-1

COUNTY OF HUMBOLDT

For the meeting of: July 21, 2015

Date: June 12, 2015

To: Board of Supervisors

From: Phillip Smith-Hanes, County Administrative Officer PSH

Subject: Additional Information on County Pension Obligations and Potential Solutions

RECOMMENDATION(S):

That the Board of Supervisors:

1. Evaluates various options for reducing the county's unfunded liability for employee pensions; and

2. Provides direction to staff with respect to desired option(s) to be brought back for action.

SOURCE OF FUNDING: All County Funds

DISCUSSION:

Humboldt County provides defined-benefit pensions to its retirees through the California Public Employees Retirement System (CalPERS). The goal of CalPERS is to amass sufficient funding during an employee's career to pay out the specified pension over the remaining expected life of the employee at the time of his/her retirement. To do so, CalPERS relies on three funding sources: employee contributions, which are established by law; investment returns, which vary according to financial market performance and provide the largest source of funding; and employer contributions, which are increased or decreased in accordance

Prepared by Phillip Smith-Hanes CAO Approval ______

REVIEW:
Auditor ______ County Counsel ______ Human Resources ______ Other ______

TYPE OF ITEM:
______ Consent
X Departmental
______ Public Hearing
______ Other ______

PREVIOUS ACTION/REFERRAL:

Board Order No. H-1, H-1, M-1

Meeting of: 2/10/15, 3/17/15, 4/14/15

BOARD OF SUPERVISORS, COUNTY OF HUMBOLDT
Upon motion of Supervisor Seconded by Supervisor

Ayes
Nays
Abstain
Absent

SEE ACTION SUMMARY

and carried by those members present, the Board hereby approves the recommended action contained in this Board report.

Dated: ______
By: ______
Kathy Hayes, Clerk of the Board

with the performance of the other two funding sources against the expectations of funding need.

Because the expectations of funding need are moving targets, adjusting employer contributions to meet these expectations each year would cause wild swings in the contribution amounts and make budgeting virtually impossible. Therefore, CalPERS phases in adjustments to employer contributions. The effect of this phasing is to create either a "superfunded" status or an unfunded liability which should be made up in future years. Humboldt County has amassed an unfunded liability over the past dozen years, and a number of factors (detailed in previous reports) have caused this unfunded liability for CalPERS pensions to grow to more than $220 million. Staff is concerned about the growth in the annual cost required to address this unfunded liability and the potential for this cost to lead to service reductions in future periods of stagnant or declining local revenues.

On February 10, your Board received a mid-year budget update and provided direction to staff regarding potential investments that could be made to reduce future cost pressures on the county's budget, including potential payments to CalPERS in excess of annually required contributions in order to pay down the unfunded pension liability. On March 17, a representative of Public Agency Retirement Services (PARS), a private firm that specializes in assisting public agencies in California with retirement and employee benefit cost control, spoke to the Board about establishing an irrevocable trust under Section 115 of the Internal Revenue Code for pre-funding of pension obligations. And on April 14, staff followed up with an additional report on various methodologies for addressing the unfunded pension liability. At that time, your Board directed staff to return with a further report. Specific issues your Board asked staff to address included:

- An understanding of the CalPERS system and the likelihood of its continuing operation;
- More detailed information about a Section 115 Trust;
- More information about Pension Obligation Bonds (POB's); and
- Likely sources of income for addressing the unfunded liability, including real property sales.

The CalPERS Retirement System

As of June 30, 2014, CalPERS had 1,715,973 members in its pension system, with just over one-third of those drawing retirement benefits. Slightly more than one-third of members are current or former school employees, with state employees and local agency employees each representing just under one-third. 1,580 local public agencies contract with CalPERS for pension benefits for their employees. As of June 30, 2013, the pension system had more than two-thirds of the amount needed to pay out anticipated retirement benefits. Between July 1, 2013, and June 30, 2014, the net investment return for the pension system was 18.4 percent, and the total market value of CalPERS investments as of April 1, 2015, was $299.6 billion.

Although it is not a direct comparison, for a sense of scale Johnson & Johnson Corporation had a market capitalization of between $276.8 billion and $300.6 billion during 2014. It was the sixth or seventh largest publicly traded company in the world at that time.

Unlike a private company such as Johnson & Johnson, CalPERS has a guaranteed source of income. Each year, employees and employers contribute more than $3 billion in new funding to the pension system. Although recent court decisions have indicated that local agencies that are bankrupt could reduce their pension obligations through the federal bankruptcy process, no agency has yet emerged from bankruptcy protection with such a reduction in place.

It should also be noted, as stated in the April 14 report, that the CalPERS pension system is designed differently than the Social Security system. Under Social Security, current employees pay the benefits of retirees. Although the system has set aside some funding in the past when the contributions into the system were in excess of the amounts needed to cover current benefit payments, the model does not work if the number of pensioners exceeds the number of current employees. CalPERS, by contrast, is a pre-funded system under which the three sources of income should contribute sufficient amounts prior to the employee's retirement date to fully fund that individual's benefit over the remainder of his/her projected life span.

While the problem facing Social Security is demographic (the relative percentages of retirees and current employees as the population ages), the issue with CalPERS is the benefit levels in relation to expected earnings and life spans. Both Humboldt County individually and the state as a whole have taken steps to address this issue by reducing the benefit levels for future retirees. Employers are also contributing additional amounts to make up for changing assumptions (part of the unfunded liability that this report seeks to address).

These facts are certainly no guarantee that the CalPERS system will continue to exist in its present form indefinitely. For example, pension reform groups continue to advocate ballot initiatives that would make changes to California law and give local agencies even more flexibility in dealing with pension benefits. In a more pessimistic view of the future, the rising cost of CalPERS benefits could lead to a critical mass of agencies being unable to make their annual payments and threaten the overall system's ability to pay out future benefits at promised levels. However, CalPERS makes its investment decisions with a view to its long-range needs, allocating funds across classes of assets with different expected maturity dates according to projected payout needs.

The current assets of CalPERS equate to more than $174,000 per member and, as noted, there is an annual income stream that is protected under existing laws. While future economic and political trends might alter this situation, CalPERS is a highly secure pension system and there is no reason to believe the county will not need to contribute to it at some level for at least the next 30 years.

Section 115 Trust

One of the potential opportunities for the county to address its long-term CalPERS obligation is to establish an irrevocable trust under Section 115 of the Internal Revenue Code. Although such trusts have been used for several years to pre-fund employer obligations for retiree health care costs, the Irvine Ranch Water District in southern California was the first agency to adapt this methodology for its pension obligations. The water district received a private letter ruling from the Internal Revenue Service supporting its trust; estimated costs for establishing an individual trust are approximately $50,000.

PARS has established a multi-agency trust for public agencies in California to pre-fund CalPERS contributions and has received an additional private letter ruling. Participation in the PARS multi-agency trust would cost the county significantly less than establishing a separate trust; the annual cost is 0.25% of assets up to $10,000,000 (e.g., $2,500 for a $1,000,000 contribution). So far, three local agencies in California (the Town of Colma, the City of Sausalito, and Solano County) and the Superior Courts in Kern County have adopted this program through PARS.

While the PARS trust could only be used to pay the county's costs for CalPERS (i.e., it could not be used for Social Security or another retirement program if CalPERS were to cease operations), it can be used to fund any county cost for CalPERS from the date of trust establishment. Since it is virtually certain that CalPERS will be in operation for fiscal year 2015-16 and that the county will be obligated to contribute $28.5 million toward CalPERS costs in 2015-16, any amount placed in the trust up to $28.5 million would be "safe" in the sense that the county's costs could subsequently be reimbursed from the trust even if CalPERS ceased operations in the future.

A primary advantage of placing funds into the trust account rather than holding them in fund balances for subsequent contribution to CalPERS is that investments in the trust can be made under the more flexible rules of California Government Code Section 53216.1 rather than the more restrictive rules of Government Code Section 53601. While the county's pooled investments earned 0.83 percent interest during the one-year period ending March 31, 2015, PARS reports that its trust assets were earning 4.45 to 7.24 percent for the same time frame.

An advantage of holding funds in trust rather than contributing an equivalent amount directly to CalPERS is that the county retains complete control over the timing and amount of disbursements from a trust. The county also controls the timing of contributions to the trust. The combination of these features would potentially allow the county to smooth out contributions to CalPERS – contributing to the trust when the county has funds available and then using the trust to pay CalPERS when the county's revenues decline.

A final advantage of the trust approach is that assets held in the trust would directly reduce the county's pension liability for financial reporting purposes.

In order to join the PARS trust, the county would need a resolution authorizing participation and designating a Plan Administrator with authority to execute implementation agreements. PARS has provided staff with samples of these documents, which could be brought back upon Board direction.

Pension Obligation Bonds

A pension obligation bond (POB) is a debt instrument issued by a local jurisdiction to finance long-term pension liability. By issuing POB's, the county would borrow funds from bondholders and use the proceeds to pre-fund the county's unfunded liability to CalPERS. The debt would then be owed to the bondholders rather than the pension system. The reason for doing this, as noted in the April 14 report, is that in the right interest rate environment the county can borrow from bondholders at a lower interest cost than CalPERS would assume to earn on its investments (and therefore effectively "charge" the county). If this works as intended, the result would be that the unfunded liability for pensions would be paid off at a lower total interest cost to the county and its taxpayers than if the county continues to make only the required minimum payment to CalPERS. Additionally, the county could structure its POB repayment obligations to better match available budget resources – a level of flexibility that is not available through CalPERS.

There are several cautionary notes to be sounded with respect to POB's:

First, paying off the existing unfunded liability provides no assurance that future investment performance or policy changes would not create a new unfunded liability or change the base "normal cost" of providing pensions. For example, CalPERS is currently examining a new policy to minimize investment risk that would gradually lower the expected rate of return for CalPERS investments. This would put more of the burden for funding pensions on employers. Thus, the county could end up both paying bondholders and facing newly rising costs for the same benefits.

Another issue with POB's is that it is impossible to know with certainty whether they save money for the county until the bonds are paid in full. This is because CalPERS investment returns are not earned at a constant rate. In instances where CalPERS out-earns assumptions, the county's unfunded liability could decline (making the POB repayments more expensive than if the county had done nothing). While it is currently assumed to be unlikely that CalPERS would drop rates to the county significantly for a large portion of the potential repayment horizon on POB's, staff does not claim the ability to make accurate predictions 20-30 years into the future. Conversely, if CalPERS earnings rates drop below the borrowing rate on the POB's the county would lose money in that the POB obligation would remain and a new liability would be created as noted above.

Unlike most debt issuances by local governments, bondholders' returns on POB's are not exempt from federal income tax. This means that the cost to the county would be higher than for other forms of debt. The reason for this is that POB's are essentially an arbitrage instrument – "playing the market" to try to achieve an interest rate spread that is advantageous to the local government.

A final consideration with respect to POB's is that they are considered risky by investors. This is because the ability to structure POB repayment obligations to account for budget resources, mentioned above, has encouraged some local governments to issue POB's as they are sliding towards bankruptcy. Moreover, POB's – unlike payments to pension systems – have been successfully discharged in municipal bankruptcy proceedings. For this reason, as well as the uncertainty associated with investment returns, the Government Finance Officers Association recommends against issuance of POB's.

Despite these issues, staff has consulted with a qualified investment bank and has reviewed a number of different scenarios for POB's. Humboldt County is not in a position of needing to seek bankruptcy protection, so to minimize the impact of the concerns and attract the maximum number of potential bond buyers, the investment bank recommends dedicating savings achieved through use of POB's to a pension stabilization fund (which could be in the form of a Section 115 trust).

Although POB's are considered an "absolute and unconditional" obligation of the issuing government, they are not subject to a vote by the public if they are judicially validated. While payable from "all legally available funds" of the issuing government, POB's are not backed by any specific revenue pledge or covenant to raise taxes. The legal theory is that the underlying pension debts are "obligations imposed by law" under the California constitution and the POB's merely change the form of this existing obligation. The first step in issuance of POB's is to contract with bond counsel to bring an action for this judicial validation. This is estimated to cost approximately $25,000. There is no deadline (or indeed commitment) to issue POB's following a judicial validation, so the county could take this step and then wait for a favorable interest rate environment to complete the process. Staff would return with a plan for this action upon direction from your Board.

It might also be advantageous to the county to break up issuance into several POB's spaced out over time, and staff is working with the investment bank on these scenarios as well.

Potential Funding Sources
Regardless of the methodology the county chooses to employ to address the unfunded liability for pension benefits, a key question is how to fund the additional expense.

As noted above, the county's planned expenditure for CalPERS in fiscal year 2015-16 is $28.5 million. Of that amount, slightly less than half ($13.46 million) is to pay for the unfunded actuarial accrued liability. Under current projections, the county's minimum contribution for this unfunded liability is anticipated to grow to $22.76 million by fiscal year 2024-25.

This increase of $9.3 million over nine years can reasonably be expected to consume nearly all available growth in basic county revenues over this period. Currently, the county's annual revenue stream from property taxes (the largest source of local discretionary revenue) is $41.94 million. If this revenue source were to increase by 2 percent annually over the next nine years, it would grow to $50.12 million by 2024-25 – an increase of $8.18 million. Thus, it is highly unlikely that there will be additional ongoing county discretionary funding to support additional expense associated with accelerated pay-down of the unfunded liability. This is especially true in view of the need to fund other expenses over the next nine years (including but not limited to expenses such as infrastructure investment, raising reserves to policy levels, and providing for employee compensation increases). And if the county experiences a recession over this period (which is likely based on historical trends), the effect could be to "crowd out" current services.

So if additional ongoing funding is not available and it is important to address this issue to avoid future service reductions, there are two basic options for securing funds: getting "more bang for the buck" by using the expected expenditure in a way that pays down the unfunded liability more quickly or identifying one-time funding sources.

The scenarios for potential POB's reviewed with the investment bank would repurpose the projected payments to CalPERS for the unfunded liability to pay bondholders instead. However, all of the scenarios show payments on POB's less than projected payments to CalPERS in some years and greater than projected payments in other years. Staff has requested additional scenarios that would stay below projected CalPERS payments throughout the term of POB repayment.

With respect to one-time sources of funding, there are two possible sources of such funding: unexpected receipts or savings and planned sales of non-renewable county assets such as real property. Typically, the county pursues a conservative strategy of not relying on revenues until there is a high degree of confidence that they will be received; accordingly, the county often receives one-time payments that were not anticipated in the budget process. Past examples of unanticipated funding sources have included payments in lieu of taxes from state and federal governments (when not anticipated at time of budget adoption), repayment of past mandate subvention funds from the state, increased property tax increment due to dissolution of redevelopment agencies, and fund balance carry-over due to unanticipated savings by departments. Over the past three years, unanticipated one-time funds have totaled:

FY 2012-13	*$1,337,157*
FY 2013-14	*$1,360,000*
FY 2014-15	*$2,246,784*

The county could reasonably direct some or all of future one-time unanticipated funding to pay down the unfunded pension liability. Although it is impossible to anticipate funding that is by definition unanticipated, it seems reasonable that the county could contribute in the realm of $500,000 annually through this methodology.

An alternative to waiting for these unanticipated sources of funding would be a planned program of liquidating county assets for cash. One of your Board's six key goals for 2015-16 is "streamlining the inventory of county properties (including through sale where appropriate) to levels that are easier to manage with current resources." Doing so could generate one-time revenues that could also be directed to pay down unfunded pension liability.

A very preliminary review of available parcels indicates that most of the county's real property assets are rights-of-way and not developable (and therefore of little value on the open market). Four potentially saleable unimproved lots were identified: a lot in Myrtletown, a lot in Ridgewood Heights, a lot at the base of Humboldt Hill, and a lot in downtown Eureka. None of these lots has a current appraisal; securing appraisals would cost approximately $3,000 per parcel. In addition, two of these parcels would require lot splits to separate out existing county facilities from the vacant parcels. Sale of any of the lots would also require a declaration by your Board that the properties are surplus and unneeded for county operations. Based on conditions and locations of the four properties, the sale of all four may generate less than $1 million for the county after accounting for expenses.

Beyond these four parcels, the county would need to examine sales of lots with current county facilities located on them (or, in the case of the gravel lot adjacent to the Courthouse, currently planned). To pursue this, staff would need to identify how those county functions could be consolidated into different facilities.

FINANCIAL IMPACT:

This item does not have a direct and immediate financial impact, but it points out future anticipated costs and provides options for minimizing those costs. Accordingly, it meets the Board's strategic framework, priorities for new initiatives, by providing core services in ways that safeguard the public trust through managing county resources to ensure the sustainability of services.

OTHER AGENCY INVOLVEMENT:

CalPERS

ALTERNATIVES TO STAFF RECOMMENDATIONS:

1. The Board could choose not to address the unfunded liability for pension costs at this time. This would leave the county in the position of paying the minimum required annually to CalPERS. This option is appropriate if the Board believes that current estimates of total 30-year cost for retiring the unfunded liability are overstated and the Board desires to use available funds for other purposes. The risk associated with this option is that the county might find itself in a position of reducing services if the cost of servicing the unfunded liability grows faster than available resources. This is most likely to occur within the first ten years of the 30-year time horizon.

2. The Board could choose to gather additional public input prior to making a decision. Other jurisdictions have formed advisory committees to review in-depth analyses of pension figures and make recommendations to elected decision-makers. Such a committee could consist of staff, community leaders with sophisticated fiscal knowledge, and/or Board members. This option is appropriate if the Board believes that it lacks sufficient information at the present time or wants to better engage the public in the process. The risk associated with this option is that it further delays direction to begin addressing the unfunded liability.

ATTACHMENTS: None.